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Analysis of China's Local Government Debt Risk Causes and Resolution Pathways

Jingjing Cui[1], Dongping Xiao[2]*

1.Shandong Provincial Student Financial Assistance Management Center, Jinan, 250002, China

2.Shandong Financial Investment Group Co., Ltd., Jinan, 250002, China

Corresponding author: Dongping Xiao, 15916761@qq.com

Abstract: In recent years, local government debt risk has emerged as a significant constraint on China's high-quality economic and social development. The continuously expanding scale of local debt, its complex structure, and notable regional disparities present substantial challenges, with county-level government debt risks being particularly prominent. Multiple factors—including real estate market adjustments, weakening land finance revenues, and tightening financing policies—have contributed to frequent debt defaults and credit risk events in certain regions, significantly intensifying debt sustainability pressures. To advance risk mitigation, authorities have implemented "three-debt integrated management," exploring the unified administration of explicit government debt, implicit debt, and local government financing vehicle (LGFV) debt. Various measures have been employed to optimize debt structure and effectively contain new debt while resolving existing liabilities, including refinancing bond replacements, platform company restructuring, asset revitalization, and financial alliances. This paper analyzes the root causes of local government debt risks, systematically examines current challenges and governance effectiveness, and proposes targeted policy recommendations. These include further strengthening long-term risk prevention mechanisms, enhancing budget constraints and information disclosure, focusing on industrial upgrading and fiscal system reform, and promoting sustainable and refined local debt management. This research provides both practical reference and theoretical guidance for local government debt risk resolution.

Keywords: Local Government Debt; Risk Resolution

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1.Introduction

In recent years, China's local government debt risk prevention and control have become a major issue affecting overall economic and social development. In May 2024, during his inspection tour of Shandong Province, General Secretary Xi Jinping specifically emphasized the need to "solidly advance risk prevention and resolution in key areas such as small and medium-sized financial institutions, local government debt, and real estate," fully reflecting the central government's high-level attention to debt risk prevention and control.

In June 2010, the State Council issued the "Notice on Strengthening the Management of Local Government Financing Platform Companies" (State Council Document No. 19 of 2010), which focused on regulating financing platforms and their financing behaviors, as well as resolutely prohibiting local governments from providing irregular guarantees and commitments. In September 2014, the "Opinions of the State Council on Strengthening Local Government Debt Management" (State Council Document No. 43 of 2014) proposed establishing a unified debt management mechanism for local governments that integrates "borrowing, using, and repaying," aiming to reasonably control local government debt scale and effectively leverage the positive role of standardized local government borrowing.

Between 2015 and 2018, the central government coordinated the issuance of replacement bonds, replacing existing government debt totaling 12.2 trillion yuan. In August 2018, the "Opinions of the Central Committee of the Communist Party of China and the State Council on Preventing and Resolving Hidden Debt Risks of Local Governments" (Central Committee Document No. 27 of 2018) clearly prohibited new implicit debt and stipulated that the resolution period for existing implicit debt should not exceed 10 years.

Since July 2023, a series of important policies have been successively introduced, including the "Guiding Opinions on Financial Support for Resolving Financing Platform Debt Risks" (Document No. 35), the "Notice on Further Coordinating Local Debt Risk Prevention and Resolution" (Document No. 14), and Document No. 134, which aim to replace high-cost, short-term implicit debt with lower-interest, longer-term government bonds to reduce debt risk. On November 8, 2024, the 12th meeting of the Standing Committee of the 14th National People's Congress approved an additional 6 trillion yuan in local government debt limits to replace existing implicit debt. The central government has also specified that 800 billion yuan will be allocated annually for five consecutive years from new local government special bonds specifically for debt resolution, potentially replacing 4 trillion yuan of implicit debt. Additionally, agreements have been made to repay 2 trillion yuan of implicit debt related to shantytown renovation projects maturing in 2029 and beyond according to contract terms.

As China's economic and social transformation continues, local government debt risk prevention has received significant attention from academia, becoming a key research topic in fiscal and financial fields. Scholars have developed relatively systematic and diverse research frameworks around the causes of China's local government debt, risk measurement, governance approaches, and its impact on the macro-economy.

Existing literature generally recognizes that local government debt issues reflect not just simple financial constraints but deeper systemic contradictions, including China's fiscal decentralization system[1], mismatches between administrative responsibilities and fiscal resources[2], path dependence on land finance[3] and local government incentive mechanisms[4]. Some scholars point out that under the new economic normal, tensions between weak fiscal revenue growth and rigid expenditure obligations have become more pronounced [5]. Coupled with local governments' heavy reliance on land transfer revenues[6]and financing platforms circumventing borrowing restrictions[7], the scale of local government implicit debt continues to expand. Regional GDP competition among Chinese local governments, while supporting growth, has driven substantial local debt increases[8].

Regarding debt prevention and resolution, some scholars propose "increasing revenue and reducing expenditure," advocating for restoring and maintaining local government fiscal sustainability to mitigate debt risks [9]. Others argue that fundamentally resolving local government debt issues requires completely eliminating soft budget constraints and establishing robust hard budget constraint mechanisms[10].

In the process of promoting economic and social development, debt levels have gradually increased, with debt service pressures becoming increasingly prominent. Particularly under the dual influence of deep adjustments in the real estate sector and changes in the external environment, local land transfer revenues have declined, fiscal resources have tightened, and debt risk concerns have further intensified in some regions. when land sales revenue decreased, local governments increased debt as a substitute. This shift created higher short-term debt pressure and faster adjustments to interest rate structures, potentially generating new financial risks[11]. To actively address these challenges, some regions have implemented "three-debt integrated management," which emphasizes "strengthening the unified management of government debt, implicit debt, and LGFV debt, resolutely controlling new debt while reducing existing debt." This approach aligns with the requirements set forth at the Central Financial Work Conference to "establish a government debt management mechanism compatible with high-quality development and long-term mechanisms for preventing and resolving local debt risks," demonstrating determination and innovative thinking in debt risk prevention and control.

However, debt risk resolution is a systematic project involving multiple domains including economic development, fiscal management, and financial stability. Recent developments show that some regions have experienced defaults on non-standard debt and commercial bill delinquencies, increasing market concerns about debt issues. How to effectively prevent and resolve debt risks while ensuring stable economic operation and promoting sustainable fiscal development represents a significant challenge for governments. Particularly during this critical period of economic transformation and upgrading, finding a path that effectively resolves existing debt risks while supporting high-quality development is of great practical significance.

This paper analyzes the current debt risk situation and challenges, examines the root causes of debt risks, and proposes targeted policy recommendations to provide decision-making references for preventing and resolving local debt risks and promoting high-quality economic development.

2.Challenges in Managing Local Government Debt Risks

As of the end of 2023, the national government debt balance reached 70.77 trillion yuan, with local government debt accounting for 40.74 trillion yuan. From a debt service perspective, overall maturity and redemption pressures have eased somewhat in 2024, but certain regions still face significant rollover pressures. Notably, some platforms have chosen to issue high-cost, short-term financing products to supplement funds, further deteriorating their debt structures. Local debt risk resolution continues to face multiple challenges, including both short-term pressures to resolve existing debt and long-term institutional issues requiring solutions.

2.1 Pressure to Resolve Existing Debt

The current stock of debt is substantial, with issues including maturity mismatches and high costs affecting certain debts. Although the government has implemented measures such as “three-debt integrated management,” challenges remain regarding the sustainability and depth of debt resolution outcomes. Particularly against the backdrop of increasing economic downward pressure, balancing stable growth with risk prevention presents a significant challenge. Under strict debt supervision, implicit debt can no longer be extended or replaced through previous non-market-oriented methods (such as trust and non-standard financing), increasing the difficulty of resolving existing debt. While new implicit debt has been compressed, suitable market-oriented innovative pathways for addressing existing debt remain elusive. Debt pressure is widespread across the province, with insufficient coordination at the provincial fiscal level slowing the process of supporting debt adjustment in financially weaker cities and counties.

2.2 Impact of Changing Financing Environment

The financing environment has tightened due to macroeconomic conditions and changes in financial regulatory policies. To prevent risks associated with local government financing platforms in recent years, the State Council and relevant institutions have successively issued documents including “Guidance on Further Improving the Prevention and Resolution of Local Government Implicit Debt Risks by Banking and Insurance Institutions” (Banking and Insurance Regulatory Commission Document No. 15 of 2021), “Guiding Opinions of the General Office of the State Council on Financial Support for Resolving Financing Platform Debt Risks” (State Council Office Document No. 35 of 2023), “Notice of the General Office of the State Council on Printing and Distributing the ‘Measures for Classified Strengthening of Government Investment Project Management in Key Provinces (Trial)’” (State Council Office Document No. 47 of 2023), and “Notice of the General Office of the State Council on Further Coordinating Local Debt Risk Prevention and Resolution” (State Council Office Document No. 14 of 2024). These policies have restricted bank financing, inter-bank and exchange bond issuance for financing platform companies. For regions and platforms with weaker credit qualifications, financing difficulties have significantly increased, and costs have risen.

The financing environment has been notably affected by real estate market weakness, local fiscal pressures, and tightened policy supervision, showing overall differentiation. This situation benefits high-rated, quality LGFV companies, as policy clarification improves market confidence and enhances the financing environment. Meanwhile, lower-rated LGFV companies will gradually exit the financing market through restructuring and integration.

2.3 Concentrated and Widespread Debt Risks at District and County Levels

District and county-level governments have become the most concentrated tiers of debt risk. These risks frequently occur in fiscally constrained county-level governments with extremely limited debt resolution capabilities, often entirely dependent on higher-level fiscal support. Field research indicates that some districts and counties have weak economic foundations and limited local fiscal revenues. To meet the needs of urbanization expansion and economic development, they often rely on LGFVs to undertake numerous public welfare and infrastructure projects, as well as investment attraction supporting construction tasks, resulting in comprehensive debt expansion and excessive debt burdens. Various degrees of debt risk are evident across district and county governments in both developed coastal regions and less developed central and western regions. In economically developed areas, despite stronger debt service capabilities, debt scales are often substantial during periods of rapid infrastructure expansion (such as industrial park construction and major transportation projects). In less developed areas, though debt scales may be slightly smaller, their significantly weaker repayment capabilities attract greater concern.

2.4 Difficulties in LGFV Transformation

In recent years, the central government has continuously strengthened restrictions on local government implicit debt. As primary vehicles for implicit debt, LGFVs face strict financing limitations, with funding channels cut off in areas such as non-standard financing and trust loans, significantly reducing their fundraising capabilities. Unlike the previous model of "debt-financed expansion and rapid construction," current policies emphasize the profitability and capital utilization efficiency of infrastructure projects, posing higher requirements for traditional "infrastructure-driven" LGFVs, especially smaller ones lacking industrial projects capable of driving transformation.

In some inland cities (such as southwestern Shandong and resource-depleted cities), land finance accounts for a high proportion of revenue. The real estate market downturn has led to sharp declines in land and related asset prices, depriving local governments of their primary leverage for capitalizing LGFVs to support debt, urgently requiring these regions' LGFVs to seek market-oriented profitability capabilities. However, their weak industrial foundations add difficulty to transformation efforts. LGFVs predominantly focus on local government projects, with highly concentrated business scopes including infrastructure construction, road and bridge development, and shantytown renovation, resulting in relatively singular profit models and heavy dependence on government fiscal support. Most LGFVs hold assets (such as land reserves and public facilities) that lack market-oriented development capabilities and face difficulties in asset revitalization and commercialization. Simultaneously, they lack truly commercial projects and operational experience, leading to a general sense of powerlessness when facing market-oriented transformation.

3.Analyzing the Causes of Debt Risk

The exposure of debt risk stems from the deterioration of balance sheets. When assets collapse while liabilities remain rigid or even expand, risks inevitably emerge. Factors triggering either asset collapse or liability rigidity and expansion can induce debt risks, which can be summarized as: difficulties in continuing the debt-financed urbanization model, internal and external pressures severing revenue streams, misalignment between fiscal responsibilities and resources breeding hidden dangers, and short-sighted performance evaluations stimulating borrowing.

First, the traditional development model relying on land finance and debt has become unsustainable. This model of operating cities through debt financing solved many operational issues during periods of economic prosperity but now faces sharp reductions in land fiscal revenues and sudden increases in debt service pressures during economic contraction.

Second, excessive borrowing by LGFVs has created substantial implicit debt. On one hand, there is ineffective supervision leading to uncontrolled debt scale; on the other hand, LGFVs have undertaken too many governments public welfare projects with low returns and long recovery periods. As important vehicles for debt financing, LGFVs suffer from insufficient profitability and persistently high debt-to-asset ratios, reduced financing channels, reliance on high-interest short-term financing, and operational difficulties.

Third, existing special bonds face significant principal and interest repayment pressures. Special bonds should be revenue bonds issued to raise funds for specific projects. However, in actual practice, some projects have been blindly initiated due to performance-oriented governance, insufficient feasibility studies, and other reasons. The actual returns on special bond projects have failed to meet expectations, with some even facing abandonment and non-performing asset issues, making the originally designated repayment sources unable to service principal and interest. Declining land prices and falling fiscal revenues have subjected local governments to dual blows in revenue and financing.

The deeper causes include: first, the mismatch between fiscal resources and administrative responsibilities has led to grassroots governments assuming numerous public service responsibilities, exacerbating debt pressures; second, the current investment and financing system rewards state-owned platform companies for excessive reliance on government credit financing, allowing many low-return or no-return projects to receive financing support, with project returns often falling short of expectations and lacking scientific risk assessment; third, distorted evaluation and incentive mechanisms encourage local officials to promote short-term economic growth through borrowing while neglecting debt risks, with misalignment between official terms and project construction and revenue cycles increasing short-term performance pressure and accumulating debt risks, while rent-seeking issues in some projects further exacerbate debt problems; fourth, localities have failed to establish stable revenue sources, with major tax revenues declining sharply, widening funding gaps and heightening debt risks.

4.Systemic Risk Prevention Recommendations

For local debt resolution, the priority is to eliminate potential landmines accumulated in previous periods. A comprehensive approach using debt resolution policies, asset restructuring, LGFV transformation, and other measures should be employed to optimize local debt structure, broaden funding sources, and reduce liability scale. At a deeper level, institutional and mechanism innovations, fiscal system reforms, and changes in local government development models are needed to build a modern economic system.

4.1 Fully Utilize Debt Resolution Policies to Continuously Optimize Debt Structure

Debt maturity mismatches represent a significant cause of debt risk. Local governments should fully leverage and utilize special refinancing bonds, government special bonds designated for debt resolution, and implicit debt replacement bonds issued by the central government to replace high-cost LGFV debt with lower-interest government debt. Financial support policies should be effectively utilized to secure loans from state-owned commercial banks and policy banks for debt replacement, converting high-interest short-term debt into low-interest long-term debt, buying time to gradually resolve debt risks.

4.2 Improve Debt Management Systems and Resolutely Prevent New Implicit Debt

Provincial governments should take primary responsibility for local government debt management, with active cooperation from city and county levels. First, a comprehensive debt management platform should be established to achieve dynamic monitoring of government and LGFV debt across the province. The monitoring scope should be expanded to include all accounts payable, and provincial-level coordinated supervision mechanisms should be constructed to prevent new implicit debt. Second, debt risk management should be elevated, establishing a three-tier linkage mechanism, setting up provincial-level risk resolution funds, and allowing provincial takeover of risk areas when necessary. Finally, risk early warning and emergency response mechanisms should be introduced, establishing a tiered risk warning system and emergency fund pool to adopt corresponding measures for debts with different risk levels, particularly for high-risk cities and counties that should be included in key control lists, with provincial coordination mechanisms established to address emergencies.

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4.4 Innovate Debt Resolution Pathways and Mobilize All Available Resources

This debt crisis requires clear recognition that the current situation differs from previous ones, with multiple factors converging. Particularly against the backdrop of weak fiscal revenue growth and sharp declines in urban asset values, previous approaches relying on increasing land transfer revenues to resolve existing issues are no longer applicable. All levels of government must prepare for extended periods of austerity. Given limited local government resources, innovative debt resolution pathways must be created, funding sources broadened, and the operability of debt resolution enhanced.

4.4.1 Revitalize Existing Assets

Revitalizing existing assets represents an effective approach to addressing debt risks. Provincial governments can promote infrastructure asset securitization, such as the introduced REITs projects valued at approximately 15 billion yuan for subways and highways. Additionally, establishing asset management platforms to integrate government assets, including industrial park equipment, factories, and land resources, can realize revenue monetization. The "debt-to-equity + income linkage" model can also be explored to handle assets that are difficult to monetize, achieving balance between debt and assets through government industrial funds.

City and county-level governments should identify integrable assets, including idle administrative and state-owned enterprise assets and unutilized public resources. Through special bonds, renovation loans, franchise rights financing, and other policies, these assets can be sold or mortgaged to reduce debt ratios.

4.4.2 Promote LGFV Reform

Market-oriented reforms of LGFVs should separate public welfare and commercial projects, with financing for public welfare projects incorporated into government special bond management and commercial projects continuously enhancing profitability to ensure cash flows from operational assets can cover financing principal and interest. City and county governments should integrate LGFVs, clearing ineffective and loss-making enterprises to substantially reduce their number, clarifying boundaries between LGFVs and local governments, and preventing irregular new financing for governments.

4.4.3 Implement Market-Oriented Debt Restructuring Plans

Debt restructuring represents an important method for resolving existing debt. Different restructuring plans should be developed based on regional and debt type differences. Debt restructuring should proceed according to classification: economically strong cities can implement market-oriented restructuring, while financially weaker regions should adopt government-led approaches through special bond replacements, debt extensions, and other measures to reduce debt service pressure. Over 200 billion yuan of debt has already been restructured in 2024. Provincial-level coordination should be strengthened by establishing provincial debt resolution funds. Consideration should be given to issuing relief bonds and establishing a 50-billion-yuan debt investment fund to support debt restructuring in high-risk areas. The fund should adopt a government-guided, market-operated model to attract social capital participation.

4.5 Construct Long-Term Mechanisms for Preventing Local Debt Risks

4.5.1 Implement More Active Debt Resolution Policies at the Central Level

China's liability ratio structure shows imbalances across different entities: local governments have high true liability ratios, and enterprise and resident leverage ratios are also elevated, but the central government maintains a low liability ratio with considerable room for additional debt. Current local government debt replacement primarily targets accounted implicit debt, aiming to repay financial institutions. The central government should consider issuing special national bonds and transferring them proportionally to local governments, primarily for paying accounts payable, effectively reducing local government and enterprise liability ratios and promoting economic development.

4.5.2 Deepen Fiscal System Reform

The key issue is resolving the mismatch between local government responsibilities and fiscal resources. The general reform direction should involve delegating fiscal authority, recentralizing administrative responsibilities, and clearly delineating government responsibilities at different levels to reduce overlaps. Government special bond reforms should implement "negative list" management for investment areas, strictly prohibiting the use of special bonds for non-revenue-generating projects. The scale of project-specific special bonds should be strictly limited, and new project-specific special bonds should be prohibited for local governments involved in new implicit debt or with poor previous records. Attention should be paid to repayment risks associated with existing special bonds in some localities; for those genuinely lacking repayment sources, temporary deferrals of principal repayments should be allowed, with rolling issuance permitted at maturity and local governments allowed to arrange fiscal subsidy funds for interest payments to prevent special bond repayment risks. Local government tax structure transformation should be promoted to construct a local tax system suitable for the post-land finance era. Budget management reform should establish a standardized, transparent budget system with strengthened fiscal discipline. Expenditures must be drastically reduced to achieve local fiscal balance.

4.5.3 Improve Government Investment and Financing Mechanisms

Following the market-oriented reform of LGFVs, the financing system primarily based on "government credit" should be thoroughly transformed. Clear credit boundaries between local governments and LGFVs should be established, and for market-operated local state-owned enterprises, rigid redemption assumptions should be broken to shift market expectations away from unlimited government backing.

4.5.4 Establish Sustainable Development Models

Local governments must transform their economic development approaches, abandoning previous models of debt-financed investment, city operations, and major investment attraction in favor of constructing favorable business environments, cultivating entrepreneurial atmospheres, and guiding private development of new productive forces.

4.5.5 Improve Local Government Evaluation Systems

The weight of debt risk in evaluation systems should be increased, while GDP and other economic indicators should continue to be de-emphasized in favor of evaluation systems oriented toward resident satisfaction and business environment quality.

Development remains the most effective means of resolving issues, with reform serving as the sustainable driving force for development.

Conclusion

In summary, China's local government debt risks stem from real estate market adjustments, declining land finances, tightening policies, and fiscal system imbalances, requiring a comprehensive approach for resolution. The "three-debt integrated management" framework offers a viable pathway that addresses explicit debt, implicit debt, and LGFV obligations simultaneously. Effective risk mitigation necessitates combining short-term measures—such as refinancing bonds and asset revitalization—with long-term institutional reforms of fiscal systems and evaluation mechanisms. Given regional disparities in debt profiles, a differentiated approach is essential, with market solutions for stronger economies and more direct interventions for weaker areas. Ultimately, debt resolution must balance financial stability with economic development, transitioning from debt-fueled growth toward an innovation-driven model that supports China's high-quality development goals while building resilient local financial systems for the future.

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